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UNCLAS SECTION 01 OF 05 JAKARTA 000393

SENSITIVE
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SUBJECT: INDONESIA -- INFORMATION IN ADVANCE OF G-20
MEETINGS

REF: (A) SECSTATE 17502 (B) JAKARTA 381

11. (SBU) Summary: The Indonesian government remains focused on protecting its economy from the effects of the global economic slowdown. The government's economic team has moved nimbly to secure alternative financing to fund an expansionary budget, secure passage of a fiscal stimulus package and tap domestic and international capital markets despite significantly higher borrowing costs. The principal challenge to Indonesia over the next few months will be to maintain domestic demand sufficient to support continued economic growth and to limit increases in unemployment and poverty.

12. (SBU) Pressure on the balance of payments (BOP) through the capital account is viewed as the central financial risk, given Indonesia's relatively modest foreign exchange reserves, uncertainty about the size of corporate foreign debt maturing in 2009 and the prospect of continued risk aversion for emerging market assets. Indonesia remains reluctant to consider going to the IMF for BOP support. A secondary concern is the growing impact of slower external and domestic demand on the Indonesia corporate and banking sectors. End summary.

SUMMARY OF KEY ISSUES
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13. (SBU) Stimulus: The legislature approved a fiscal stimulus package in the amount of IDR 73.3 trillion (about USD 6.1 billion, or 1.5% of GDP) on February 24, 2009. The package is heavily weighted toward tax measures, including decreases in marginal income tax rates that became effective January 1. The package includes IDR 12.2 billion (USD 1 billion) in additional infrastructure spending. Many observers question whether the government will be able to implement infrastructure spending (in both the stimulus program and the regular 2009 budget) quickly enough to boost domestic demand and mitigate job losses, given GOI capacity constraints in implementing these programs.

14. (SBU) Financial Sector: Indonesian financial

institutions largely avoided significant exposure to the bad assets weighing on many institutions' balance sheets. The largest 15 banks are considered well-capitalized, but non-performing loans are rising and capital adequacy ratios declining. Observers consider current pressures on the banking sector manageable, but the outlook on credit quality continues to deteriorate. On the regulatory front, Indonesian issued additional foreign exchange regulations to reduce speculation in late 2008. Authorities have said they plan to issue additional regulations addressing off-shore products, including derivatives-related instruments in 2009. The government has also delayed implementation of higher minimum capital levels for insurance companies, blaming current financial market conditions.

15. (SBU) Real Economy: Indonesia has focused on supporting domestic demand to protect jobs and maintain economic growth. With global demand weakening and concern about dumped imports increasing, the GOI implemented new import restrictions on five categories of goods (apparel, footwear, toys, electronics and food and beverages). The GOI limited the number of entry points for these goods to prevent "illegal" imports which could harm domestic firms employing Indonesian workers. While Chinese imports appeared to be the primary target, the restrictions negatively

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affected all imports in these categories. The GOI has defended these regulations as WTO consistent. See Jakarta 391 and Jakarta 69 for additional reporting on other protectionist measures, views and government statements on the WTO. The dramatic decline in prices of key Indonesian commodity exports has also undermined economic growth and is expected to weigh on investment in 2009.

16. (SBU) Social/Labor Impact: The fiscal stimulus is aimed at supporting domestic demand and limiting job losses. Some significant layoffs in the textiles and manufacturing sectors have occurred, though most employers have avoided layoffs by cutting back on hours. The Indonesian Employers Association has said that employers are trying to avoid widespread job losses until after legislative elections in April and presidential elections in July. If the downturn deepens, however, more widespread job losses in 2009 are likely. The government has increased funding to its main anti-poverty program (PNPM, National Community Empowerment Program), which provides block grants to communities, creating employment opportunities in areas such as small infrastructure projects.

Few public protests relating to the economic crisis and government response have occurred, in part due to continuation of direct cash payments to poor families through February 2009. A limited number of labor protests took place in late 2008 when the government attempted to limit increases in the minimum wage to the rate of forecast economic growth.

17. (SBU) Dimension of the Crisis: GOI officials are concerned both about the depth and duration of the economic slowdown. They are concerned about their ability to obtain affordable financing given the substantially higher interest rates demanded by capital markets for emerging market government bonds. Indonesia has advocated on behalf of emerging markets for greater resources to be channeled through the multilateral development banks to support

developing countries' government expenditures, consistent with medium-and long-term development priorities. As co-lead of Working Group IV on reform of the multilateral development banks, Indonesia favors establishment of a Global Expenditure Support Fund which would assist developing countries in funding countercyclical spending. The Working Group has not endorsed this proposal.

¶8. (SBU) Role of the G-20: Indonesia views the G-20 as the right group of major developed and developing countries to coordinate a response to the financial and economic crisis. It has made a significant contribution to the process through its role as co-chair of Working Group IV. See Jakarta 157 and 2008 Jakarta 2058 for additional reporting on this issue.

¶9. (U) Please see Jakarta 381 for responses to specific questions I(A) through (D).

II. Impacts of the Global Financial Crisis:

¶10. (SBU) Indonesian authorities are concerned about adequate access to U.S. dollar liquidity. FM Wirajuda asked Secretary Clinton for USG assistance in obtaining a bilateral currency swap during her recent visit to Jakarta. Japan recently doubled its bilateral currency swap with Indonesia through the Chiang Mai Initiative currency swap lines. The amounts Indonesia could draw would be small absent an IMF program. Bank Indonesia seeks to augment its foreign currency reserves in order to increase its ability to dampen rupiah volatility in the currency market

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and to ease potential balance of payments concerns. Officials are also seized with the need to finalize Financial System Safety Net domestic legislation establishing a legal framework for handling crises involving systemically important financial institutions. A revised draft Financial System Safety Net law remains stalled in the legislature, after legislators rejected a framework established by government regulation.

¶11. (SBU) The most important impact of the crisis on Indonesia's financial sector has been significant capital flight from Indonesian stock, bond and currency markets and resulting currency weakness. Reduced capital inflows and tight U.S. dollar liquidity have contributed to rupiah volatility, placing stress on smaller, less well-capitalized financial institutions. Although the banking sector remains generally well-capitalized, a number of banks experienced significant derivatives-related losses following sharp depreciation of the rupiah. Analysts believe these losses are manageable and do not pose systemic risks. Domestic bank NPLs have increased in recent months, reflecting pressure on Indonesia's commodities and manufacturing sectors. The Deposit Insurance Corporation took over one medium-sized bank, Bank Century, which received a capital injection of USD 208 million.

¶12. (SBU) NPLs are expected to increase in 2009, given pressure on the corporate and consumer sectors. Domestic lending to the corporate sector has declined, following robust 30 percent lending growth in 2008. BI expects overall lending growth of 15 percent in 2009, although some private banks expect to limit loan growth to 5 to 10 percent. See Jakarta 227 for additional details on pressures on the banking sector.

¶13. (SBU) Indonesian authorities have reacted

to the crisis with a robust policy response. It quickly lined up contingency financing of about USD 5.5 billion from the World Bank and other development partners (Japan, Australia and the ADB) to fund an expanded budget deficit of 2.5% to support the expansionary fiscal measures described above. Meanwhile, Bank Indonesia has significantly eased monetary policy, lowering its overnight policy rate by 175 basis points from December through March, to 7.75 percent, as inflationary pressures receded. For an extensive list of measures taken by the government (including a 20-fold increase in the deposit insurance guarantee), please see 2008 Jakarta 2008. Note: the proposed bailout of Bank Indonesia-owned Bank Indover did not occur, as the Indonesian legislature failed to formally approve the proposed bailout. Netherlands banking authorities closed Indover and are in the process of resolving the institution. See 2008 Jakarta 2207 for information on the government takeover of and capital injection into Bank Century.

III. The Broader Economic Crisis

¶14. (SBU) The most important impact on Indonesia's real economy has been a significant slowdown in the six-plus percent economic growth rate Indonesia enjoyed in 2007 and 2008. Without growth of six to seven percent, Indonesia cannot reduce its poverty and unemployment rates. In the fourth quarter of 2008, GDP declined by 3.6 percent (q-o-q). Government efforts to mitigate the impacts of the economic crisis include the stimulus package and reductions in the price of subsidized fuels to improve purchasing power. To alleviate the impact of slower growth on the poor, the government continued direct cash payments to poor households through February 2009.

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It has also targeted subsidies to provide key products such as cooking oil at reduced prices.

¶15. (SBU) Indonesia has also seen an accelerating, sharp decline in trade. January exports fell by 36.08 percent on-year and 17.7 percent on month, after declines of 20.56 percent (y-o-y) and 9.57 percent (m-o-m) in December and monthly double-digit declines in October and November. Import declines have been comparable. January imports fell by 33.99 percent on year and 17.63 percent on month. Industrial production has also fallen, down 3.4 percent in the fourth quarter of 2008. Government efforts to mitigate these impacts include the stimulus package, import restrictions and a nascent domestic goods promotion campaign. Job losses, including among Indonesia's many migrant workers, are also increasing. See Jakarta 91, Jakarta 62 and 2008 Jakarta 2247 for additional reporting on employment and trade finance.

¶16. (SBU) The crisis has affected Indonesia's outlook on trade and investment. While many officials recognize an increased need to compete for foreign investment, other officials have embraced a more protectionist, nationalist stance. These sentiments are reflected in the increased use of non-tariff barriers to reduce imports. For example, Indonesia's Food and Drug Agency (BPOM) has begun applying more stringently regulations for imported food products. See Jakarta 391 and Jakarta 69 on additional protectionist measures and 2008 Jakarta 2092 regarding new regulations on foreign exchange transactions. On a more positive note, Embassy has seen a preview of proposed revisions to the Indonesian Investment Law which should improve Indonesia's overall investment regime. The GOI has also provided limited tax incentives (reduced income tax rate, accelerated depreciation) for investment

in specified sectors and/or regions. See 2008 Jakarta 1872.

¶17. (SBU) Embassy is not aware of a local preference provision in the stimulus package, but we understand the government intends to issue implementing regulations to an existing Presidential Instruction mandating domestic products be purchased for any government procurement. The government has not acted to spur devaluation of the rupiah to improve export competitiveness. The government has publicly encouraged BI to maintain rupiah stability. BI intervenes selectively to dampen rupiah volatility.

IV. Near-term Outlook and Political/Foreign Policy Ramifications

¶18. (U) Regarding the changing macroeconomic outlook, see Jakarta 264, Jakarta 106 and 2008 Jakarta 2300. Growth projections continue to be revised downward. The current consensus estimate for 2009 growth is 3.5 percent, but several private-sector analysts predict growth will fall to between 1.9 and 2.6 percent. Inflationary pressures have moderated, with BI expecting inflation to fall to 5 to 7 percent in 2009, from 8.6 percent on-year in February, well off the peak of over 12 percent in September. After firming in December, the rupiah has weakened again in recent weeks, trading at around IDR 12,000/USD. The biggest economic challenge facing Indonesia in 2009 is maintaining sufficient domestic demand to support positive economic growth and prevent a large increase in poverty and unemployment. The government has accessed domestic and capital markets in 2009, but has had to offer significantly higher interest rates than in 2008.

¶19. (SBU) Potential political ramifications for Indonesia in this election year include how voters view the Yudhoyono administration's management of the economic crisis. A deep economic downturn could harm SBY's

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re-election chances, with more populist/nationalist candidates benefiting. The administration's strong policy response to the crisis reflects the significant concerns they have about this possibility. See 2008 Jakarta 2319 for additional information. Closer economic cooperation within the ASEAN plus three grouping may signal greater reliance on regional, rather than multilateral institutions, and on regional partners. However, these regional programs are still being developed. They have not yet distributed support funds and remain contingent on an IMF program for access to large-scale report. Regarding social ramifications of the crisis, a deeper downturn could provoke demonstrations such as those which occurred in May/June 2008 following the government's unpopular fuel price hike. The government has been able to respond to such incidents with measures, such as direct cash payments to the most vulnerable families, that have alleviated underlying pressures. Another factor buffering social pressure stemming from an economic downturn is the flexibility of the Indonesian labor market. Laid-off workers are able to earn income, albeit meager wages, in Indonesia's large informal sector.

¶20. (SBU) Regarding government criticism of the United States for its role in the crisis, Indonesian government officials, including President Yudhoyono and Finance Minister Sri Mulyani Indrawati, have frequently described the crisis as a financial tsunami which originated elsewhere, sometimes citing the U.S. specifically and sometimes referencing developed markets more generally. Indonesia is portrayed as an innocent victim hit by the turmoil. While

officials have criticized lapses in regulatory oversight of complex financial instruments related to the financial crisis, they have generally refrained from overly harping on the United States and its role in the crisis. Some GOI officials, such as Sri Mulyani and Trade Minister Pangestu, have publicly taken relatively nuanced approaches on the "Buy America" provision, noting it had little impact on Indonesia or likening it to the kind of promotion of domestic goods Indonesia is beginning to undertake itself.

¶21. (SBU) The economic downturn may create some bilateral irritants with Indonesia's neighbors, e.g. with Malaysia if large numbers of Indonesian migrant workers are dismissed, and with China, with whom Indonesia has a number of commercial disputes which appear linked to the economic crisis (e.g. stalled Chinese financing of power plant projects and a dispute over an Indonesian state-owned enterprise's purchase of Chinese aircraft). Embassy does not expect these irritants to become more serious issues which change Indonesia's foreign or security policy.

¶22. (U) Source of foreign assistance: the GOI is not a significant donor of foreign assistance, so the crisis does not impact its ability/commitment to sustain foreign assistance levels.

¶23. (SBU) Impact on government support for global peacekeeping operations/commitments to NATO operations: We do not expect the economic crisis to affect Indonesia's small, but important contribution to peacekeeping operations, although it may prompt the GOI to request more foreign funding of such assistance. The GOI may be more reluctant to assume more peacekeeping missions, however, absent additional foreign support.

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